

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-886-00

MDFriedman

date: April 4, 2000

to: Chief, Examination Division, Southern California District
Attn: Lynda Winter E:PSP Room 3401 and
Karen Schiller, E; PSP:ESC

from: MILES D. FRIEDMAN
Attorney

subject: [REDACTED]
EIN: Unknown

Taxable Years Involved: [REDACTED], [REDACTED], [REDACTED], and [REDACTED]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Attached hereto are a slightly revised memorandum from the one I gave you on February 22, 2000 and a copy of the memorandum I received from the National Office yesterday. There were only a few changes to the February 22nd memorandum that the National Office wanted to make. These include removal of the cites to [REDACTED], in the paragraph beginning at the bottom of page 6 of the earlier memorandum, and changing language in the following sentence at the top of page 8:

In determining the allowable amount of earned income under section 32, a taxpayer owning a sole proprietorship must reduce his earned income by an amount equal to the deduction allowed under section 164(f) for half of the self-employment taxes. [emphasis added]

to read:

In determining the allowable amount of earned income under section 32, a taxpayer owning a sole proprietorship must reduce his net profit by an amount equal to the deduction allowed under section 164(f) for half of the self-employment taxes. [emphasis added]

The two page memorandum from the National Office reiterates what we spoke about last month. The most important new comment is by a reviewer, who penned at the bottom of the memorandum: "Also Field must verify that Freeze code preventing issuance of refund will not expire." Please have someone verify that the Service Center will not remove the freeze code and issue refunds to anyone.

Please telephone me at 360-3430, if you have any questions.

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:WR:SCA:LN:TL-N-886-00
MDFriedman

date: March 24, 2000

to: Chief, Examination Division, Southern California District
Attn: Lynda Winter E:PSP Room 3401 and
Karen Schiller, E; PSP:ESC

from: MILES D. FRIEDMAN
Attorney

subject: [REDACTED]

EIN: Unknown

Taxable Years Involved: [REDACTED], [REDACTED], [REDACTED], and [REDACTED]

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On February 14, 2000, we met at your request to discuss the refunds of earned income tax credit generated by tax returns prepared by individuals in an entity called the [REDACTED]. Attorney Willis Douglas and Coordinator Karen Reynolds also attended the meeting.

Issues

1. Do the deficiency procedures apply?
2. Should the Service assess the self-employment tax reported on the returns?
3. Should the amended return be combined with the original return and a deficiency determined therefrom?
4. (b)(7)a, (b)(7)e
(b)(7)a, (b)(7)e

Conclusions

1. Yes. I.R.C. § 6211(b)(4) specifically includes the I.R.C. § 32 earned income tax credit ("EIC") in the definition of a deficiency.

2. Probably no, especially if you learn the [REDACTED] prepared amended returns for [REDACTED] include a sole proprietorship that lacks any basis in reality. If you are unsure about the fictitious nature of the particular Schedule C or Schedule C-EZ, then you should assess the self-employment tax. Since the self-employment tax is considered to have been paid by the EIC reported on the amended returns, your assessment should just be a bookkeeping entry that will not start a collection process against the particular taxpayer. This assessment can be abated when more facts are learned.

3. Yes.

4. (b)(7)a, (b)(7)e
(b)(7)a, (b)(7)e

(b)(7)a, (b)(7)e

We are coordinating this matter with the National Office. We expect to send this memorandum to the National Office for post-review. We will immediately notify you if any of the above conclusions change.

(b)(7)a, (b)(7)e
(b)(7)a, (b)(7)e

(b)(7)a, (b)(7)e

(b)(7)a, (b)(7)e

Facts and General Discussion

Our understanding of the facts is derived from your rendition of them at the February 14th meeting.

Approximately [REDACTED] low income taxpayers filed original returns for their [REDACTED], [REDACTED], [REDACTED], and [REDACTED] taxable years. We assume for purposes of this memorandum that the Service is not examining any of those returns for any reason unrelated to the activities of the [REDACTED].

These same low income taxpayers learned the [REDACTED] could prepare amended returns for them. The [REDACTED] prepared amended returns for their clients in [REDACTED] and [REDACTED]. We have reviewed two amended returns. In each such amended return, the [REDACTED] included a Schedule C-EZ that had gross receipts and net income. Calculated from the net income on each of the two amended returns was an EIC amount and a self-employment tax amount. A refund was requested for an amount of EIC net of the self-employment tax. We discuss these two returns in more detail below.

The Fresno Service Center has in some instances refunded the amounts requested on the [REDACTED] prepared amended returns, while in other instances it has frozen the refund requests.

Some individuals did not timely file their original tax returns. It appears that for these individuals, generally, the return the [REDACTED] prepared for them would be their original tax return for the year involved.

We recommend you concentrate now on just the [REDACTED] taxable years of the [REDACTED]'s clients. We also recommend you do not examine until after [REDACTED], those taxpayers whose original returns for [REDACTED] were actually prepared by the [REDACTED] in [REDACTED] or [REDACTED]. This is because the statute of limitations for assessment started when those late returns were filed, which was in [REDACTED] or [REDACTED] for those taxpayers for whom the [REDACTED] prepared original [REDACTED] year tax returns. In other words, if the first income tax return the Service received from the taxpayer was the one prepared by the [REDACTED] in [REDACTED] or [REDACTED] for that taxpayer's [REDACTED] taxable year, then please put that return aside because, unless there is something unusual, there should not be an [REDACTED] statutory problem with that return. Please err

on the conservative side, so that if you are unsure if the [REDACTED] prepared return, executed in [REDACTED] or [REDACTED] for a [REDACTED] taxable year is the original tax return, assume it is not and that the statute expires on [REDACTED], for that taxpayer's [REDACTED] taxable year.

The remaining returns should encompass just amended returns prepared by the [REDACTED] for a taxpayer's [REDACTED] taxable year.

We assume for purposes of this memorandum that all taxable years ended on December 31, [REDACTED]. Please inform us of any instance in which our assumption is incorrect, since the remaining recommendations in this memorandum might not apply in such an instance.

Please separate those instances in which the Fresno Service Center actually issued a refund to the taxpayer for his or her [REDACTED] taxable year from those in which the Fresno Service Center froze the requested refund. We recommend you work the cases in which the Fresno Service Center actually issued a refund to the taxpayer for his or her [REDACTED] taxable year first. This is because the statute of limitations probably expires on [REDACTED]. I.R.C. § 6501(a). We hope time and resources will permit you to write audit reports and issue notices of deficiency to those taxpayers whose [REDACTED] related refunds were frozen, but that is not as critical as writing audit reports and issuing notices of deficiency to those taxpayers whose [REDACTED] related refunds were actually paid.

There is an alternative to the notice of deficiency procedure. That alternative involves the institution of a lawsuit by the Department of Justice in the United States District Court for the recovery of an erroneous refund. I.R.C. § 7405. The statute of limitations for such an action is 2 years, unless the United States can prove fraud or misrepresentation. I.R.C. § 6532(b). Then the statute of limitations is 5 years. Id. (b)(7)a

(b)(7)a We would need to review specific cases that are well developed before we could consider recommending this alternative. In the emergency atmosphere we are in, this alternative is not feasible. We would consider this alternative for cases involving the [REDACTED] taxable years of individuals you determine, after full case development, can and should be brought to the attention of the Department of Justice. Feel free to

¹Telephone conversation between Miles Friedman and Peter Reilly, an attorney in the Procedural Review section of the Office of Chief Counsel in the National Office, 2/17/00.

involve us early on in this process.

Specific Facts of the Two Taxpayers

During our meeting you showed us two tax returns. You copied the entire administrative files for each of them. These administrative files consisted of the IRS transcript that contains information about the original return and a copy of the single page electronic filing of the [REDACTED] related amended tax return. In both instances, the taxable year was [REDACTED].

a. [REDACTED]

[REDACTED], SSN: [REDACTED], is the first taxpayer. From the transcript, it appears [REDACTED] had wages of \$ [REDACTED], withholding of \$ [REDACTED] and EIC of \$ [REDACTED]. Her filing status was 4, head of household, and she had three exemptions, one for her and two for two children. After application of the exemption amount, \$ [REDACTED], [REDACTED] had zero taxable income. The Service refunded her \$ [REDACTED], the total of the withholding of \$ [REDACTED] and EIC of \$ [REDACTED].

The single page 1040 PC Format return filed by the [REDACTED] also specified that [REDACTED] was a head of household with two children. However, instead of wages, [REDACTED] was now a [REDACTED] with her own business. The [REDACTED] prepared an electronic Schedule C-EZ. That form showed [REDACTED] had \$ [REDACTED] in gross receipts, \$ [REDACTED] in expenses and \$ [REDACTED] in net profit. [REDACTED] also had self-employment taxes of \$ [REDACTED] and a schedule SE deduction of half the self-employment taxes, or \$ [REDACTED].

The [REDACTED] computed the EIC to be \$ [REDACTED]. This was done by subtracting the deduction for one half of the self-employment tax (\$ [REDACTED]) from the \$ [REDACTED] of net profit to arrive as [REDACTED]'s earned income of \$ [REDACTED]. Then the EIC Table shows a credit of \$ [REDACTED] when a taxpayer has \$ [REDACTED] in earned income. The [REDACTED] netted this \$ [REDACTED] against the self-employment taxes of \$ [REDACTED] to arrive at a refund of \$ [REDACTED].

We cannot tell from the transcripts whether the Fresno Service Center issued a \$ [REDACTED] refund.

b. [REDACTED]

From the transcript, it appears [REDACTED] had wages of \$ [REDACTED], withholding of \$ [REDACTED] and EIC of \$ [REDACTED]. Her filing status was 4, head of household, and she had three

exemptions, one for her and two for two children. After application of the exemption amount, \$ [REDACTED], [REDACTED] had \$ [REDACTED] of taxable income and a tax liability of \$ [REDACTED]. The Service refunded her \$ [REDACTED], the total of the withholding of \$ [REDACTED] and EIC of \$ [REDACTED], less the \$ [REDACTED] of tax liability.

The single page 1040 PC Format return filed by the [REDACTED] [REDACTED] also specified that [REDACTED] was a head of household with two children. However, instead of wages, [REDACTED] was now a [REDACTED] with her own business. The [REDACTED] prepared an electronic Schedule C-EZ. That form showed [REDACTED] had \$ [REDACTED] in gross receipts, \$ [REDACTED] in expenses and \$ [REDACTED] in net profit. [REDACTED] also had self-employment taxes of \$ [REDACTED] and a schedule SE deduction of half the self-employment taxes, or \$ [REDACTED].

The [REDACTED] computed the EIC to be \$ [REDACTED]. This was done by subtracting the deduction for one-half the self-employment tax (\$ [REDACTED]) from the \$ [REDACTED] of net profit to arrive at [REDACTED] earned income of \$ [REDACTED]. Then the [REDACTED] EIC Table shows a credit of \$ [REDACTED] when a taxpayer has \$ [REDACTED] in earned income. The [REDACTED] netted this \$ [REDACTED] against the self-employment taxes of \$ [REDACTED] to arrive at a refund of \$ [REDACTED].

We cannot tell from the transcripts whether the Fresno Service Center issued a \$ [REDACTED] refund.

Legal Analysis

(a) Requirements for EIC

I.R.C. § 32(a)(1) permits a taxpayer to claim an earned income credit against his income tax liability if he is an "eligible individual." An eligible individual is defined in section 32(c)(1)(A)(i) to include someone who has a qualifying child. Otherwise, an individual is eligible for EIC if: (a) his principal place of abode is in the United States for more than one-half of the taxable year, (b) he is at least 25, but not yet 65 years old on December 31st of the year in question, and (c) he is not a dependent of someone else under section 151. I.R.C. § 32(c)(1)(A)(ii).

A qualifying child is an individual who satisfies a relationship test, a residency test, and an age test. I.R.C. § 32(c)(3)(A). In order to claim the EIC the taxpayer must include the qualifying child's social security number on the return. I.R.C. § 32(c)(2)(B).

In general, a taxpayer's minor son or daughter, who lives in his home in the United States, and has a social security number should be a qualifying child. Vidmar v. Commissioner, T. C. Memo. 1999-168. However, in each instance, the exact statutory requirements should be reviewed to make sure the child is a "qualifying child" under I.R.C. § 32(c)(3).

The EIC can be phased out or eliminated when an individual makes too much money. Under I.R.C. § 32(a)(2):

The amount of the credit allowable to a taxpayer under paragraph (1) for any taxable year shall not exceed the excess (if any) of --

(A) the credit percentage of the earned income amount, over

(B) the phaseout percentage of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds the phaseout amount.

The applicable credit percentages and phaseout percentages are at I.R.C. § 32(b).

I.R.C. § 32(c)(1)(C) provides that if two or more individuals would otherwise be eligible for the earned income credit with respect to the same qualifying child for the same taxable year, only the individual with the highest adjusted gross income for the taxable year will be eligible to claim the qualifying child.

A married person must file a joint return. I.R.C. § 32(d). The Service provides tables to help taxpayers determine their EIC. I.R.C. § 32(f). A taxpayer with too much investment income does not qualify for the credit. I.R.C. § 32(i). In years after 1996, if a taxpayer improperly claimed a credit, he might not be allowed to claim it for a period of time. I.R.C. § 32(k).²

I.R.C. § 32(c)(2)(A)(i) defines the term "earned income" to

² I.R.C. § 32(k) applies to 1997 and years thereafter. Since we limit our legal discussion to [REDACTED], we do not comment on this Code section. However, we would like to consider it when there is time to tackle the [REDACTED] and [REDACTED] related tax returns. Please advise us when you are ready to review the [REDACTED] and [REDACTED] taxable years of individuals who had the [REDACTED] prepare original or amended returns.

include, wages, salary and other employee compensation. Under I.R.C. § 32(c)(2)(A)(ii), "earned income" also includes a taxpayer's net earnings from self-employment. In determining the allowable amount of earned income under section 32, a taxpayer owning a sole proprietorship must reduce his net profit by an amount equal to the deduction allowed under section 164(f) for half of the self-employment taxes.³

Under I.R.C. § 6401(b), when a taxpayer's EIC exceeds his tax liability, the excess is considered to be an overpayment.

It is of seminal importance that a person actually has earned income in order to obtain the credit. Powers v. Commissioner, T.C. Memo. 2000-5. The earned income credit was a means to encourage people to obtain employment through essentially a refund of some or all of the Social Security Tax a low-income taxpayer paid. Id., citing to S. Rept. 94-36 (1975), 1975-1 C.B. (Part II) 590, 603 to accompany the Tax Reduction Act of 1975, Pub. L. 94-12, 89 Stat. 26, sec. 204.

It is also of critical importance that a person actually has a sole proprietorship⁴ in order to be able to have net earnings from self-employment. The definition of the term "net earnings from self-employment" in Code section 1402(a) includes the requirement that a trade or business actually be carried on by that individual.

██████████ was a ██████████ in the ██████████ created sole-proprietorship, while ██████████ became a ██████████ in her own business. If during the course of your examination of these two individuals, you learn that they did not actually carry on the ██████████ claimed businesses, then you can disallow the earned income credit the ██████████ claimed for them. Under that scenario, since there would be no net earnings from self-employment, there would also be no self-employment tax or section 164(f) deduction. Therefore, if you find during the course of your examinations of the ██████████ prepared returns for ██████████ and ██████████ that the Schedules C-EZ were not based on

³ This is a generalization. Net earnings from self-employment is a term that is defined in I.R.C. § 1402(a) and the regulations thereunder.

⁴ We limit our discussion to a sole proprietorship because that is what was on the Schedules C-EZ prepared by the ██████████ for the two taxpayers involved in this matter. We recognize that one does not have to own a sole proprietorship to have net earnings from self-employment.

reality, then we opine that you should not have to assess the self-employment taxes stated on those documents. However, if you are unsure the [REDACTED] prepared returns for [REDACTED] and [REDACTED] are bogus, then you could assess the reported self-employment tax.

Theoretically, you could also examine [REDACTED] and [REDACTED] original returns to determine if they have met the technical requirements for the earned income credit. Given the amount of time remaining until [REDACTED], we leave that up to you. In the remainder of this memorandum, we assume [REDACTED] and [REDACTED] original returns are accurate and correct.

(b) Deficiency Procedures

(1) Deficiency Procedures Apply

The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") added the following to the definition of a deficiency:

(A) Any excess of the sum of the credits allowable under sections 32 and 34 over the tax imposed by subtitle A (determined without regard to such credits), and

(B) any excess of the sum of such credits as shown by the taxpayer on his return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits),

shall be taken into account as negative amounts of tax.

The above language is now at I.R.C. § 6211(b)(4).

The legislative history to section 6211(b)(4) states that TAMRA added the new section because Congress wanted to make it clear that: "Tax Court deficiency procedures apply to credits allowable under section 32 . . . notwithstanding that the credits reduce the net tax to less than zero." H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 366, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 387.

The United States Tax Court has dealt with cases that have as the only issue whether the taxpayer is entitled to a claimed amount of EIC. See Powers v. Commissioner, T.C. Memo. 2000-5.

This means that the deficiency procedures are to be followed if you determine that [REDACTED] and/or [REDACTED] are not entitled to the EIC claimed for them by the [REDACTED] on the respective amended returns it prepared for them.

(2) Application of Deficiency Procedures⁵

A deficiency is generally calculated by the following formula: A deficiency equals:

- (1) the correct tax imposed,
- (2) minus the total of the tax on the taxpayer's return,
- (3) minus prior assessments of deficiencies,
- (4) plus rebates.

For purposes of this computation, the credit for tax on withheld wages, I.R.C. § 31, is disregarded.

When the EIC is involved, the tax imposed is the correct tax minus the correct EIC.⁶

Similarly, when the EIC is involved, the tax shown on the taxpayer's return is the tax shown on the return, less the EIC claimed thereon.

Then, the deficiency is the tax imposed minus the tax shown on the return. And when the total of the tax on the taxpayer's return is a negative, while the tax imposed is zero, the result is zero minus a negative number, which equals a positive deficiency.

In summary, the Service cannot assess a decrease in EIC (or an increase in tax) unless it first issues the taxpayer a notice

⁵ Some of the material in this section is taken from SCA 1997002. The SCA, however, cannot be cited as precedential authority.

⁶ Technically, any section 34 credit would have to be added, as required under I.R.C. 6211(b)(4). However, we believe it will be rare for you to find any credit for special fuels and or gasoline that was either claimed or allowed under I.R.C. § 34 on a [REDACTED] related original or amended tax return. If you find such a rarity, please seek advice from us as to how to calculate the deficiency.

of deficiency. Also, the fact a requested refund has been frozen by the Fresno Service Center has no impact on whether a deficiency should be issued.⁷

In [REDACTED] case there is a deficiency of \$ [REDACTED]. This is calculated as follows:

The correct tax is zero minus \$ [REDACTED] of correct EIC, yielding a tax imposed of -\$ [REDACTED].

[REDACTED] combined returns show a tax of \$ [REDACTED]. They also show EIC totaling \$ [REDACTED]. (\$ [REDACTED] on original return plus \$ [REDACTED] on [REDACTED] prepared return.) \$ [REDACTED] - \$ [REDACTED] = -\$ [REDACTED]. Therefore, -\$ [REDACTED] is the tax shown on [REDACTED] two returns.

Then, the deficiency is \$ [REDACTED], which is the tax imposed minus the tax shown on the two returns: -\$ [REDACTED] minus - [REDACTED] = \$ [REDACTED].

In [REDACTED] case, the deficiency is \$ [REDACTED]. This is calculated as follows:

The correct tax is \$ [REDACTED] minus \$ [REDACTED] of correct EIC, yielding a tax imposed of -\$ [REDACTED].

[REDACTED] combined returns show a tax of \$ [REDACTED]. (\$ [REDACTED] + \$ [REDACTED]) They also show EIC totaling \$ [REDACTED]. (\$ [REDACTED] on original return plus \$ [REDACTED] on [REDACTED] prepared return.) \$ [REDACTED] - \$ [REDACTED] = -\$ [REDACTED]. Therefore, -\$ [REDACTED] is the tax shown on [REDACTED] two returns.

Then, the deficiency is \$ [REDACTED], which is the tax imposed minus the tax shown on the two returns: -\$ [REDACTED] minus -\$ [REDACTED] = \$ [REDACTED].

Our calculations of the above two deficiencies assume there will be no change to either [REDACTED] or [REDACTED] original returns for their [REDACTED] taxable years. It is apparent that the deficiency will also be equal to the amount of the refund requested on the [REDACTED] prepared amended returns. This

⁷ This is made clear in SCA 1997002. The frozen refund means a taxpayer is considered to have paid the tax he owes so that he could file a claim for refund. We do not discuss refund litigation in this memorandum. If you seek to learn whether taxpayers can file claims for refunds frozen by the Fresno Service Center, please request that from us after [REDACTED].

should be the case when such returns contain what we suspect are fictitious Schedules C or C-EZ.

Please contact attorney Miles Friedman at 360-3430 if you have any questions.

MILES D. FRIEDMAN
Attorney